

PCLL Conversion Examination
January 2016
Examiner's Comments
Commercial Law

This Report sets out the Examiner's general comments on issues to be addressed in answering the questions in Parts A, B and C of the January 2016 Commercial Law Exam.

Part A (Sale and Acquisition of Goods)

Overview

The majority of students chose to answer Question 1 on the sale of goods and most students achieved satisfactory marks. The minority of students, however, who chose to answer Question 2 with an essay evaluating the importance of the *nemo dat* rule in 21st century Hong Kong commercial law almost all achieved exceptionally high marks for excellent answers.

Question 1

This is a technical question requiring students to have a detailed grasp of many of the important practical aspects of the *Sale of Goods Ordinance* ('SOGO'). Many students discussed section 3 (1) on the definition of a contract, defined "goods" within section 2 and identified the definition of "price" in section 10.

- Is time of the essence in this contract?
Some students failed to discuss the importance of sections 12 SOGO and 13.
Was delivery at 10 am a condition specified in the contract? If yes, then the Buyer could have repudiated the contract.
Students should point out that, in any event, the Buyer did not treat the late delivery as either a breach of warranty (section 12) or attempt to repudiate the contract (section 13). Time therefore only became of the essence when the Buyer stipulated delivery at 6 pm. Billy delivers at 6.15 pm. Once time is of the essence, Buyer can reject goods for 15 minutes' late delivery (*Union Eagle*).
- What is Buyer's duty under SOGO?
Buyer's duty under section 29 is to accept and pay for the goods but section 36 (2) allows Buyer reasonable time to examine goods for conformity with the contract. Buyer can reject goods if there has been a breach of an express or implied term of the contract.
- Merchantable quality and fitness for purpose -implied terms of the contract

Merchantable quality is defined in section 2(5). Some students failed to analyse the luxury aspect of these canned goods or to point out that the label “Top Quality Luxury “is clearly essential to the price Buyer is prepared to pay. Note also that the price paid by the Buyer is a factor in deciding what is and what is not merchantable quality. Note also section 16(3) in respect of luxury quality element in terms of resale and fitness for purpose.

- Seller’s obligation if cans are not of merchantable quality?
Missing labels and dents are clearly serious defects for Buyer in this case. If property has NOT passed the Buyer would be able to reject the goods.
- Description of the goods -section 15
Where description of goods is a term of the contract even a minor defect can trigger breach of contract (*Arcos*).
- When did property in the goods pass?
Note that property in the goods can only pass when goods are appropriated and ascertained i.e. when 1.000 boxes are separated from mixed goods on lorry, section 20 Rule 5 will apply in absence of any differing intention. The fact that Buyer stops lorry driver from unloading all the boxes means that in any event there is no appropriation at the time of late first delivery.
- Passing of risk property -sections 19 and 22
Where delivery is delayed through the fault of either the Buyer or Seller, the goods are at risk of the party at fault, unless otherwise agreed. When property is transferred, however goods are at Buyer’s risk whether delivery is made or not. The Buyer sent the lorry away at 2 pm.
In respect of the 2pm delivery property in the goods has not yet passed since the driver had not finished setting aside the 1,000 cans and Buyer has not had an opportunity to inspect. Even if property had passed the Buyer sent the lorry away and ordered a 6pm delivery, the Seller through the Carrier (driver of the transport company) continues to have the duties of a Bailee.
- Section 20 Rule 5(1) -unconditional appropriation
The cans are loaded onto the lorry as mixed goods. Students must at a minimum discuss relevance of:
Healy v Howett /Re London Wine (goods part of an identified bulk - unascertained goods)
Carlos Fiederspiel & Co SA v Charles Twigg
- Who bears the risk of damage to the goods? Sections 18 and 19

Are goods specific or unascertained? section 18 - No property can pass in unascertained goods. The Seller bears the risk unless property in the goods has passed. For ascertained goods students should highlight section 19 -property passes when the parties intend it to pass. The court will look at the conduct and circumstances of the case.

- Sections 37 and 38

Note that Buyer can reject goods and is not obliged to return the goods to Seller. On these facts, since property in the goods has not passed the Seller bears all risk of damage to goods.

- Carrier's duty as Bailee of goods

Note that Seller will have a claim against Carrier of the goods as Bailee of the goods but that does not affect the Buyer's remedies against Seller under Sale of Goods Ordinance. The Seller here is obliged to pay damages to Buyer and must claim separately against Carrier.

Question 2

Students should analyse the balancing act between two conflicting principles in the common law and explain the meaning of the Latin *nemo dat quod non habet* Students should also demonstrate a clear understanding of how SOGO and the *Factors Ordinance* seek to impose rights on *bona fide* purchasers with legitimate expectations in opposition to the *nemo dat* principle. Students should therefore discuss the *nemo dat* principle and how it interferes with the normal legitimate commercial expectations of business people requiring an analysis of exceptions to *nemo dat* principle in SOGO and *Factors Ordinance*, with a particular emphasis on the definition and significance of a mercantile agent.

As an essay question, students are expected to explain the meaning of and the differences between

- Mercantile agent
- Voidable title
- Seller in possession
- Buyer in possession

The best students explained that a transferee can never get a better title than that of the transferor (no one can give a better title than he himself possesses) and highlighted Lord Denning's comment in *Bishopsgate Motor Finance Corp Ltd* [1949] 1KB 322

The *nemo dat* principle is designed to protect a man's property but commercial law seeks to protect commercial transactions – the person who takes in good faith and for

value without notice should get a better title. The common law therefore seeks to find a balance between upholding sanctity of property and giving effect to a commercial transaction. The conflicting rule is that the person who takes in good faith and for value without notice should get good title. Note that in 21st century HK the law leans towards the innocent purchaser and away from the strict legal rights of the owner of the property and one reason for this is that the true owner often voluntarily transfers possession of the goods to the rogue. The true owner is usually in a position to assess risks involved in dealing with the rogue (e.g. creditworthiness, checking of address, ID card etc.) but the buyer is in **NO** position to assess risks as it is impossible to check title on goods

- Exceptions to *nemo dat* in SOGO and *Factors Ordinance*

SOGO section 23(1) estoppel

Students were required to discuss SOGO section 23(1) on the application of estoppel - the buyer may acquire good title even if the seller does not have one provided that the owner of the goods is by his conduct precluded from denying the seller's authority to sell.

Section 23(2) nothing in SOGO affects the *Factors Ordinance* enabling the apparent owner to dispose of the goods as though he were the true owner thereof.

- Section 3 *Factors Ordinance*

Students were also required to explain the meaning of a mercantile agent definition in *Factors Ordinance* section 2 (authority in customary course of business to sell goods or consign them). This means that the Seller must be in possession of the goods or document of title at the time of the transaction; must take place in the ordinary course of business; the buyer must take the goods in good faith and without notice that the sale was made without the owner's authority.

- Sale in market overt SOGO Section 24

Where goods are openly sold in a shop in the ordinary course of business buyer acquires good title if he buys them in good faith and without notice of any defect of title.

Note that section 24 does not apply to a shopkeeper who purchases goods from the public in his own shop.

- Sale under a voidable title section 27(1) SOGO

Where a person having sold goods continues to be in possession of the goods or document of title ...

This section seeks to protect an innocent purchaser who is deceived by the seller's apparent ownership because of seller's physical possession or possession of documents of title. The buyer must act in good faith with no notice of the first

sale.

In order to claim under section 27(1) the second bona fide Buyer must show that Seller continues in possession of the goods or document of title and, secondly, that there was delivery of possession between seller or his mercantile agent and second Buyer. (*Michael Gerson (Leasing) Ltd v Wilkinson*).

Note *Pacific Motor* – immaterial as to what capacity the Seller retains possession which might otherwise alter the legal title. Also note *Mitchell v Jones* and the problem of a lack of “continued possession”. In this scenario the second Buyer is not protected.

- Buyer in possession section 27(2)

This section is complex and applies specifically to hire purchase agreements (*Lee v Butler*).

First buyer must obtain possession of the goods or document of title.

First buyer makes a delivery of goods or transfer of document of title to second buyer.

Second buyer must take goods or document of title with no notice of any lien or other right of original seller of the goods.

The effect of this section is to give the transfer or delivery by B1 to B2 the same effect as if delivery or transfer was authorised by the owner. Thus B2 has good title.

Part B (Personal Property)

Overview

The majority of students chose to answer Question 1 and generally achieved a satisfactory standard. Those students who chose to answer Question 2 achieved, for the most part, excellent marks and displayed a first class understanding of the problems in personal property law generally.

Question 1

This question requires an overview of the meaning of and the problem relating to SM attempting to create a fixed charge over book debts. Some of the best students also discussed issues relating to insolvency/ preferential creditors /relationship between receiver and liquidator.

Under Clause 1 of Debenture the Bank purports to create a fixed charge as security for the loan over all the Company's plant, machinery vehicles, computers, office and other equipment and chattels and book debts.

Note that despite the labelling in Clause 1 of Debenture which purports to create a fixed charge, it is the characteristics of the relationship and the terms of the charge that will define the nature of the charge, not the label attached to it by the parties *Re Spectrum* [2005] UKHL 41.

- What is a book debt?

Students should explain that a book debt of the company is any outstanding amount due to the company from a debtor upon which the company could sue for the money due.

Note that Clause 1 expressly excludes 'stock in trade' and 'work in progress' which are covered by Clause 2 of the Debenture.

Students should explain to SM that in practical terms, the fixed charge is taken over assets that are not used in the day-to-day business of the company, assets which will not be sold as part of a Company's normal business/trading activity.

- *Illingworth v Holdsworth* (1904) AC 355

A fixed charge is a charge on the specific assets of a company such as land, buildings or plant and machinery. Once created the chargor (i.e. the Company) cannot fully deal with the asset in the ordinary course of business or in any other way and the asset is paralyzed until repayment of the loan.

- How, if at all, can SM protect itself?

The single most important characteristic of the fixed charge is that the Company must obtain the consent of the fixed charge holder (SM) before dealing with the asset.

If the Company fails to obtain SM's consent before dealing with the asset, the

Company is in breach of the charge agreement. In relation to book debts this is dealt with in Clause 2.2 under realization of debts.

Clause 2.2 -This clause seeks to prevent the Company from having access to its cash flow. Students should explain the significance of Clause 2.2 in the context of **Re Spectrum [2005] UKHL 41.**

In reality a business cannot operate without access to its cash flow i.e. book debts and thus clause 2.2 will become inoperable as a fixed charge.

- Advantages and disadvantages of a fixed and floating charge from Bank's perspective as secured creditor

From Bank's point of view, the most advantageous security to take over a company's assets is a fixed charge since the holder of a fixed charge security takes absolute priority over the floating and unsecured creditors in the event of the company being wound up.

- The distinguishing characteristic of the fixed charge and problems with Clause 2.2

The fixed charge holder can exercise its powers of sale by appointing a receiver to sell the assets captured by the fixed charge and repay the debt out of the proceeds of the sale of those assets.

A fixed charge usually seeks to include and cover within its terms:

- Land and buildings
- Fixed plant and machinery (i.e. of a permanent nature in the business)
- Intellectual property rights
- Uncalled share capital (if any) in the company
- Goodwill (notoriously difficult to quantify in monetary terms) and
- Receivables i.e. book debts

- Clause 2.1

The first floating charge created under Clause 2.1 is a continuing security that covers all of the other assets of the company, from time to time and both present and future of any nature wherever situated. The best students will explain significance of:

- "Beneficial owner"- legal title in the assets does not pass to the Bank but interest attaches immediately
- "Continuing security" - the amount remains fully payable on all accounts irrespective of amounts paid into one particular account and the security remains in force until full amount of secured debt has been paid off
- Protects bank against operation of Clayton's Case
- Clause 2- Floating charge- ***Yorkshire Woolcombers Association (1903) 2 Ch 284***
By contrast a floating charge does not attach to specific assets but floats over the general property of the Company and the Company can deal with the asset during

the ordinary course of business without first asking for the consent of the charge (Bank). The characteristic of the floating charge is that allows the Company to deal with its assets whilst providing its assets as security for a loan.

The asset remains under the full control of the company before the charge crystallizes into an equitable fixed charge and typical examples of assets that are often secured by a floating charge are:

- Stock in trade
- Raw materials
- Book debts
- ***Re Bond Worth Ltd*** Slade LJ explains the genius of the floating charge as being a commercial mechanism with mutual benefits for the secured creditor and the Company. The Company has access to funding by way of charging business assets while operating business as usual.
- Disadvantages of floating charge for the Bank
 - Postponed to later fixed charges
 - Ranks behind preferential creditors
 - Subject to challenge from liquidator
- Whilst the floating charge has many advantages from the company's point of view, there is no doubt that, from the creditor's perspective, there are several weaknesses to this form of security:
 - The assets may depreciate in value;
 - The Bank must monitor the financial health of the company with frequent financial updates otherwise it cannot identify financial problems quickly enough;
 - The Company can create a later fixed charge that takes priority over the earlier floating charge - the problem of the negative pledge clause;
 - Priority is affected not only by the date that the charge was created but also by the nature of the charge, whether it is fixed or floating and whether it is legal or equitable. This means that a later fixed charge takes priority over an earlier floating charge unless there is a restriction in the floating charge on the company's power to grant a later fixed charge and the holder of the later fixed charge had notice of the floating charge and the restriction.

Question 2

The best student analysed the issues by reference to:

- *Far East Structural Steelwork Engineering Limited*
- *Official Assignee of Madras v Mercantile Bank of India*
- Professor Goode's analysis in *Legal Problems of Credit and Security*

Most students focussed on the following and achieved satisfactory marks in answering this essay type question.

- Definition and meaning of a pledge
A type of bailment. The pledge is one of the earliest forms of security and is a type of bailment and the debtor is the pledgor and the creditor is the pledgee.
A pledge is the actual or constructive delivery of possession of an asset to the creditor by way of security, but with ownership remaining with the pledgor.
A pledge is a form of consensual security transferring possession of pledged property. This consensual security takes the form of the pledgor transferring possession of the pledge the property to the pledgee. The property serves as security and pledgee takes possession of the property.
Pledgor retains the general property in the pledge. Since pledgor retains the general property on the pledged asset, pledgor may transfer it during the currency of agreement. Therefore, pledgee may become liable in conversion for wrongfully failing to allow pledgor's transferee to redeem.
Security of only intermediate strength – a pledge considered to be half-way between a lien and a mortgage in terms of strength.
- Meaning of a documentary intangible and document of title
Define “documentary intangible”? Examples of documentary intangibles are: Bill of lading/trust receipt/ negotiable instruments such as “Bearer cheques”. Note that the essential quality of a documentary intangible is that the document embodies the underlying entitlement so as to confer on the holder for the time being rights of action against the obligor.
- Delivery may be either actual or constructive
It is not necessary for creditor to take actual possession of goods but can take
 - (i) Constructive delivery of possession –bill of lading
 - (ii) Attornment NB 3rd party can attorn to the creditor to undertake to hold goods for benefit of creditor
 - (iii) Trust receiptThis made the pledge particularly useful for banks financing the import of goods against a pledge of shipping documents. Contrast the pledge with a mortgage, where the creditor acquires ownership and the mortgagor usually retains possession.
- What is the problem for modern commercial law in respect of the pledge as a security device?
Only the Bill of Lading is a real document of title and therefore the trust receipt and negotiable instruments such as cheques do not represent the underlying title and right to the goods.

Part C (Consumer Credit and Protection)

Overview

The majority of students answered Question 2 on the Unconscionable Contracts Ordinance. Most students who answered Question 1 on the doctrine of relation back achieved a high level of sophisticated analysis of the problems relating to unsecured creditors in current Hong Kong insolvency law and are to be commended.

Question 1

1. Cap 32 and the *Bankruptcy Ordinance* (cap 6)
 - The fundamental purpose of Hong Kong's insolvency law (derived from bankruptcy law) is to provide a fair and orderly process for dealing with the financial affairs of insolvent companies. Note that the doctrine of relation back was formally abolished by the *Bankruptcy (Amendment) Ordinance*. Section 42 Bankruptcy Ordinance now provides that where a person is adjudged bankrupt, any disposition of property made by the person from the day of the presentation of the petition is void except to the extent it was made with the consent of the court or subsequently ratified by the court.
 - For a company the equivalent is section 182 *Companies (Winding-up Miscellaneous Provisions) Ordinance* (cap 32).
 - The relevant provisions of the *Bankruptcy Ordinance* (cap 6) provides the framework of Hong Kong's insolvency law together with the *Bankruptcy Ordinance* on avoidance provisions
 - Statutory presumptions in respect of associates are not particularly helpful

The best students noted that Bankruptcy Winding-up Rules apply to a company and that Section 264 of the Companies Ordinance provides that the bankruptcy rules shall apply to the winding up of insolvent companies.

2. The doctrine of relation back, the commencement of the winding-up and the commencement of the bankruptcy
- 2.1 The doctrine of relation back is an old bankruptcy law term that was introduced into corporate insolvency in the mid-19th century

What does relation back mean?

This doctrine is concerned with maximizing the assets available to the Trustee in Bankruptcy. Normally court orders take effect from the date they are made by a judge.

However, the doctrine of relation-back operates to bring into the bankrupt estate,

property owned by the bankrupt in a period 6 months before the Bankruptcy Order is made by a court for anyone who is NOT an associate of the company. The relevant time for an associate is 2 years.

2.2 The commencement of the winding-up

To understand the doctrine, students need to highlight the significance of:

“the date of the bankruptcy”

“the commencement of the bankruptcy”

2.3. Commencement of a bankruptcy

Where a creditor’s petition is used, then generally the bankruptcy is taken to have relation back to, and to have commenced at, the time of the commission of the earliest act of bankruptcy committed by the person within the period or 6 months immediately before the date on which the creditors petition was presented (i.e. filed).

Students must relate this to cap 32 as corporate insolvencies is based on the much older bankruptcy.

2.4 Debtor not permitted to deal with his property

“Where a person commits an act of bankruptcy, that person is not entitled to deal with his or her estate. He or she has no right to gather it in if not already in his or her hands or to make payment to his or her creditors out of that which he or she has actually at his or her command. He or she can have no good discharge to a debtor who pays him or her with notice of the act of bankruptcy, because the debt made by subsequent bankruptcy proceedings will be turned into a debt due to his or her trustee, and not to himself or herself.”

Ponsford, Baker & Co v Union of London and Smith's Bank Ltd [1906] 2 Ch 444

3. What is an unfair preference?

Section 266B (cap 32) and section 50 *Bankruptcy Ordinance cap 6*

- A company gives an unfair preference if the person given the preference is one of the company’s creditors or a surety or a guarantor for any of the debts or liabilities of the company, and the company does something which has the effect of putting that person into a position which, in the event of the company being wound up, is better than the position he would have been in if that thing had not been done.
- The effect is that where a company is wound-up and it has, at the relevant time, given an unfair preference to any person, the liquidator may apply to the court for an order that the position should be restored to what it would have been if the company had not given the unfair preference

3.1 Note the avoidance provisions on unfair preference in section 266B (cap 32)

- Fraudulent preference is now deemed to be unfair preference as provided in section 50 *Bankruptcy Ordinance* (cap 6)

Note Section 50(3) of the *Bankruptcy Ordinance* provides that a debtor gives an unfair preference to a person if:

- that person is one of the debtor's creditors or a surety or guarantor for any of his debts or other liabilities;
- the debtor does anything which has the effect of putting that person into a position which, in the event of the debtor's bankruptcy, will be better than the position he would have been in if that thing had not been done;
- the bankrupt was insolvent at the time of the transaction or he became insolvent in consequence of that transaction, see section 51(3) of the *Bankruptcy Ordinance*.

Section 50(4) of the *Bankruptcy Ordinance*

provides that the court shall not make an order in respect of an unfair preference given to any person unless the debtor was influenced in deciding to give it by a desire to produce the effect mentioned in subsection (3)(b).

Section 51(3) of the *Bankruptcy Ordinance*

provides that a debtor is insolvent if

- he is unable to pay his debts as they fall due
- or the value of his assets is less than the amount of his liabilities, taking into account his contingent and prospective liabilities.

4. Transactions with associates of the company –

statutory presumption and problems for liquidators

4.1 If it appears that the unfair preference has taken place in favor of an associate of the company, the liquidator can go back up to two years to overturn transactions of this nature. There is a statutory presumption that the debtor was influenced by a desire to improve the creditor's position.

4.2 Problems for liquidators in proving unfair preference with non-associates

4.3 How to establish the company's state of mind?

Liquidators must prove that the transaction was motivated by the debtor company's desire to prefer a creditor. The debtor company's subjective state of mind has to be established by examining the states of mind of the various corporate officers and employees

4.4 Defense of genuine pressure

A defendant in a preference action is entitled to rely on the defense that genuine pressure was exerted on the debtor, even where the presumption of desire applies in transactions involving associates.

- Note for example, *Trustees of the Property of Hau Po Man Stanley (in bankruptcy) v Hau Po Fun Ivy* [2005] 2 HKC 227 where moral pressure was held to be as real as commercial pressure.
5. Statutory rebuttable presumption for non–associate in relation to transactions within 6 months from commencement of the winding-up
Note that it is often too easy for a non-associate to rebut the presumption. Genuine pressure to pay a bill will rebut the presumption that company was influenced by a desire to put the creditor into a better position.

Question 2

in order to achieve a pass.

This is a difficult question but the majority of students chose to answer it.

To pass students were required to discuss aspects of the following five points

1. Background to UCO
 - The Unconscionable Contracts Ordinance (“UCO”) applies to contracts for the sale of goods and services.
 - The contract between the debtor and the Hang Seng Credit card company was one for the supply of credit under which the bank was treated as lending money to the debtor to purchase goods or obtain services.
 - Since creditor was a bank and was exempt from the provisions of the *Money Lenders Ordinance*. The court could, however, examine the clause to see if UCO applied.
2. UCO remedies under Section 5 UCO
 - If the clauses relating to payment were unconscionable on the grounds of being unreasonable, the court may excise those clauses from the contract.
3. Students were required to suggest factors constituting “unconscionability” including, for example,
 - The equality of the parties-The creditors were in a much stronger bargaining position and the contracts were standard form contracts without any contribution to the drafting by the debtors.
 - The ability of the debtor to understand the ‘cost’ clause? The clause must be explained to the debtor and drawn to his attention when signing the contract.
 - The availability of identical services from another source? There was no choice because in Hong Kong most of these kind of contracts contain the same terms.
4. All factors were considered in the debtor’s favour and *contra proferentem* the credit card company. Therefore, the court held the clause was NOT enforceable

because it was unconscionable.

5. Could a Bank avoid such allegations in the future?

Bank could redraft contract to show that it:

- red-flagged the clause;
- suggested independent legal advice to avoid suggestions of undue influence;
- explained the clause in detail;
- narrowed the scope of the clause to specific situations

But it is in fact difficult to see how the Bank can ever address the problem of the relative strengths of bargaining positions of the parties.